



*Andrew Junkin, CFA, CAIA  
Managing Director*

December 1, 2010

Dr. George Diehr  
Chairman of the Investment Committee  
California Public Employees' Retirement System  
400 Q Street  
Sacramento, CA 95814

Re: Corporate Governance Investments Program Review

Dear Dr. Diehr:

Wilshire has conducted a review of the internally-managed Corporate Governance Investments Program's personnel, investment process, external managers, and resources. This review was conducted as part of Wilshire's contractual requirement to periodically review all of the internal asset management functions, and included meetings and teleconferences with existing and potential Program managers and with the CalPERS team overseeing the Corporate Governance Investments Portfolio, and ongoing discussions with both. This year, in addition to our ongoing monitoring and review of the program and each of the managers, our review focused largely on how CalPERS Staff views the current state of the program and the outlook for the future of the program in light of the newly implemented capital allocation model within the Global Equity Program.

**Wilshire recommends that the Investment Committee continue to support the Corporate Governance Investments Program, recognizing the ongoing evolution of the program, as discussed below.**

### **Overview and Performance**

As we have noted in prior reviews, Wilshire believes that the role of the Corporate Governance Investments Program is to add value to CalPERS' equity portfolio, exceeding the returns of the internally managed index funds. The program is a component of the Global Equity asset class and includes investments with external managers and co-investments made by Staff in concert with the external managers. A beneficial related effect is that the improvements in corporate governance in the Program's portfolio is also enjoyed by CalPERS' index funds, as they hold substantially all investable equity securities around the globe. Assuming that improvements in

corporate governance lead to improved stock performance, the effects of the Program are then magnified throughout the entire equity portfolio.

The performance of the program over the last ten years has been exceptional – adding 5.2% of value on an annualized basis versus the Program’s benchmark and adding 4.8% of value versus the total Global Equity benchmark over the same time period. Over the intermediate time periods (3 years and 5 years), the returns have been challenging as the Program has underperformed the broader market in total. Performance has improved over the last couple of years has improved following a challenging period in 2008.

	<u>Market</u> <u>Value</u>	<u>Qtr</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>	<u>10 Year</u>	<u>Date</u>
<b>Total Corporate Governance</b>	<b>4.5</b>	<b>10.0%</b>	<b>7.7%</b>	<b>-8.8%</b>	<b>-0.6%</b>	<b>6.6%</b>	<b>12/98</b>
<i>Policy Index</i>		9.6%	5.9%	-8.9%	0.0%	1.4%	
<i>Value Added</i>		0.4%	1.9%	0.1%	-0.5%	5.2%	
<b>Total Domestic Corporate Governance</b>	<b>2.4</b>	<b>11.5%</b>	<b>12.6%</b>	<b>-5.4%</b>	<b>-0.2%</b>	<b>10.0%</b>	<b>12/98</b>
<i>Policy Index</i>		10.4%	11.3%	-4.5%	2.2%	0.5%	
<i>Value Added</i>		<b>1.1%</b>	<b>1.3%</b>	<b>-0.9%</b>	<b>-2.5%</b>	<b>9.6%</b>	<b>12/98</b>
<b>Total Int'l Corporate Governance</b>	<b>2.1</b>	<b>8.2%</b>	<b>1.4%</b>	<b>-12.2%</b>	<b>-1.1%</b>	<b>3.1%</b>	<b>12/98</b>
<i>Policy Index</i>		8.6%	-1.0%	-13.6%	-2.8%	2.2%	
<i>Value Added</i>		<b>-0.4%</b>	<b>2.4%</b>	<b>1.4%</b>	<b>1.7%</b>	<b>0.9%</b>	<b>12/98</b>

## Process

The investment process is unchanged from last year’s review and the process remains appropriate in Wilshire’s opinion. As a reminder, the process for selecting external managers is a demanding one. There are four key steps: 1) sourcing, 2) internal due diligence, 3) external due diligence, and 4) sizing.

Sourcing new managers for the externally managed portion of the portfolio can be challenging as successful activist approaches require a melding of investment talent with the ability to identify profitable and achievable engagements. In addition, investment managers need to be able to persuade corporate management of the proposed course of action. In addition, CalPERS has always pursued a friendly-activist approach, rather than risk being viewed as a corporate raider. This is one of CalPERS’ core values, but further limits the available talent pool. Sourcing is conducted by Staff (aided by outside resources, such as Wilshire) and greatly benefits from CalPERS’ reputation as a shareowner-rights proponent.

As a reminder, internal due diligence starts with informal discussions and progresses to a formal questionnaire, developed by Staff. The questionnaire focuses on the investment process, the engagement process, the stability of the investment management firm, and the background of the key individuals. The questionnaire is very thorough, and when completed can fill a hundred pages or so. If the questionnaire receives a “passing” score,

additional due diligence is conducted by Staff onsite. If that due diligence is deemed successful, an external consultant is engaged to complete independent due diligence.

External due diligence is completed by a consultant selected by the CIO, in conjunction with the SIO-Global Equity and the SPM of Corporate Governance. A favorable due diligence report is required before an investment can be made in a new corporate governance fund. Wilshire has acted as an independent due diligence source on many, but not all of the Corporate Governance Investment Program's investments. While we cannot speak to the full due diligence process used by other firms, Wilshire's process focuses on the stability of the investment management organization; the alignment of interests between the firm, its key professionals and CalPERS; the firm's ability to add value through identifying undervalued companies and engaging with corporate management; the ability to control risks; and the ability to successfully implement the investment process through prudent trading practices.

If a favorable due diligence report is rendered on a potential corporate governance fund and Staff has decided to proceed under its delegated authority, Staff decides on the appropriate size of the investment, taking into consideration the expected risk and return characteristics of the new fund and the overall state of the Corporate Governance Investments portfolio. Such considerations may incorporate feedback from Wilshire and the Risk group within CalPERS.

Ongoing monitoring is performed separately by Staff and by Wilshire. Staff and Wilshire then coordinate to discuss any issues or concerns with the portfolio or any of the external managers.

The co-investment process is comprised of five key steps: 1) sourcing, 2) due diligence, 3) trading, 4) monitoring, and 5) an exit strategy.

Sourcing for co-investments is an active process between Staff and existing external managers. By policy, co-investments can only be made with managers that have generated outperformance since inception. Staff routinely discusses portfolio companies with managers and co-investment ideas are originally sourced during these discussions.

Once a co-investment is proposed, the proposing investment manager will prepare a write-up, detailing the rationale behind the co-investment and the keys to unlocking the underlying value through corporate governance tactics. Staff will review the research provided by the manager and conduct their own research, which may include stress testing forecasted financial statements, contacting analysts who cover the company to discuss the prospects for the firm, and review the co-investment in the context of the overall Corporate Governance Investments portfolio. Staff thoroughly reviews each option – accepting some, declining others.

Trading in co-investments is conducted by the CalPERS equity trading desk. Traders will coordinate with the Corporate Governance Staff to establish a timeline and price target for the trade. Wilshire has reviewed CalPERS trading ability extensively with other internally managed programs and finds that CalPERS has a very effective trading desk that is properly motivated to achieve best execution on all trades.

Ongoing monitoring is conducted by Staff, in conjunction with the co-investment's sponsoring manager. Staff may decide to exit a position it believes has become problematic, even if the co-investment's sponsoring manager still holds the position.

Co-investments are initiated with target engagement topics and associated price targets. As the engagement progresses, Staff will ultimately decide to sell the investment when it is believed that substantially all of the value of the engagement has been realized.

Overall, we believe that the Corporate Governance Investment Program's two investment functions (funds and co-investments) are handled appropriately and receive significant attention from Staff.

### **Current Issues**

There are three main issues facing the Corporate Governance Investments Program currently: 1) the new capital allocation model, 2) the alignment of interests between CalPERS and the Program managers, and 3) the outlook on where activist strategies can best add value.

First, as we noted last year, the ongoing evolution of the Global Equity portfolio with respect to the new capital allocation model raises issues about how the Corporate Governance Investment Program will be incorporated into the total Global Equity portfolio going forward. In its current state, the capital allocation model cannot easily process the nature of the Corporate Governance Investment Program's managers. The capital allocation model is focused on balancing the expected risks and returns of the total equity portfolio based on expectations about the nature of a given portfolio's future returns (return, standard deviation, skewness, and kurtosis). Given the concentrated nature of the portfolios in the Corporate Governance Investment Program and the resulting volatility, the capital allocation model would choose to eliminate each of the Corporate Governance Investment Program's managers, despite the significant value added by the Program over the long term. Therefore, Staff must currently find a subjective way to integrate the capital allocation model's output with the state of the Corporate Governance Investment Program to manage both. Wilshire believes that Staff should work to find a way to incorporate the Corporate Governance Investments Program into the capital allocation model and has suggested using the risk and return characteristics of the entire program as a solution (rather than manager by manager). Staff should evaluate this option to see if it is workable or if there are alternate solutions.

Additionally, Staff is considering how best to benchmark the external managers. As each manager has a concentrated portfolio, sector concentration is inevitable. As a result, performance relative to a broad benchmark could simply be a function of the manager's sector weights, rather than any investment skill or activism impacts. Other impacts could be regional weights, style and/or size biases, etc. Creating a "better" benchmark will be difficult, but would allow for a purer evaluation of manager skill and for adjustments to be made in the rest of the Global Equity program to compensate for a manager's exposures (a Japan overweight by a Corporate Governance manager might be offset by a Japan underweight in the internally managed index fund, for example). These adjustments, in turn, would allow for more effective use of a Global Equity risk budget.

Second, Staff is currently working with the Corporate Governance Investment Program's external managers in an effort to better align CalPERS' interests with those of the managers. Much of this effort is focused on lowering asset based fees and on implementing fees for meeting or beating appropriate (see comments above) performance objectives, improving the liquidity of the investments (shortening or eliminating lockups, etc.), ensuring that fees are paid only on invested capital rather than committed capital, etc. This process is ongoing, but could result in changes to the manager lineup as those firms that are unable or unwilling to meet CalPERS' terms will likely be terminated. Clearly, any new manager will have to agree to terms such as those that are being examined with existing managers.

Third, evidence from the Corporate Governance Investment Program indicates that activism may be more effective in less efficient markets – small cap, less developed, etc. Staff is evaluating the implications of this. While small cap companies and less developed markets may be attractive, there may be fewer qualified managers operating in those markets. In addition, if, in the extreme, the Corporate Governance Investment Portfolio were to transition to small cap emerging markets only, the internally managed index fund would likely need to underweight small cap emerging markets or the overall equity portfolio would end up with an obvious bias. Again, this draws attention to the fact that the current version of the capital allocation model cannot incorporate the Corporate Governance Investments Program into its analysis.

These three issues are somewhat linked in the ways described above. As a result of these issues, new investments, both with external managers and with co-investments, are at a standstill. Staff continues to meet with potential managers, but new investments are unlikely until these issues are resolved. Additionally, Staff and Wilshire continue to monitor the existing portfolio. Any performance or organizational issue that warrants termination will be acted upon and the proceeds would be reinvested in the rest of the global equity portfolio.

### **Portfolio Characteristics**

As we have noted in our prior reviews, the portfolio is very concentrated. This concentration manifests itself in a number of ways. Examples include size and style biases, relative sector weights, historical tracking error, and forecasted tracking error. We will examine each of these in turn.

To judge the magnitude of the size and style bias in the portfolio, Wilshire prepared the following analyses. Charts I and II show the style bias as revealed by returns based style analysis. In this analysis, a regression analysis finds the mixture of return streams that best fits the returns generated by the domestic and international components of the Program. In 2008, we examined the “best fit” style since inception and both the domestic and international portfolios demonstrated significant value biases, which met with our expectations. In 2009, the analysis revealed the “best fit” was about 57% large growth with the remainder split between micro cap and large value. Chart I and II examine the most recent three year period to provide additional perspective to the Investment Committee.

Both domestically and internationally, the portfolios have exhibited some growth bias over the past three years. It is worth noting that returns based style analysis can be “fooled” by anomalous returns. For example, a value manager that had excellent returns in the late 1990’s would have shown a tilt towards growth using this methodology. In this regard, it appears to us that as the returns since 2008 have improved, this analysis “views” that as being underweight some value sectors, most likely finance which has behaved erratically over the past three years.

Chart I  
Corporate Governance Investment Program  
Domestic Equity – Returns Based Style Analysis

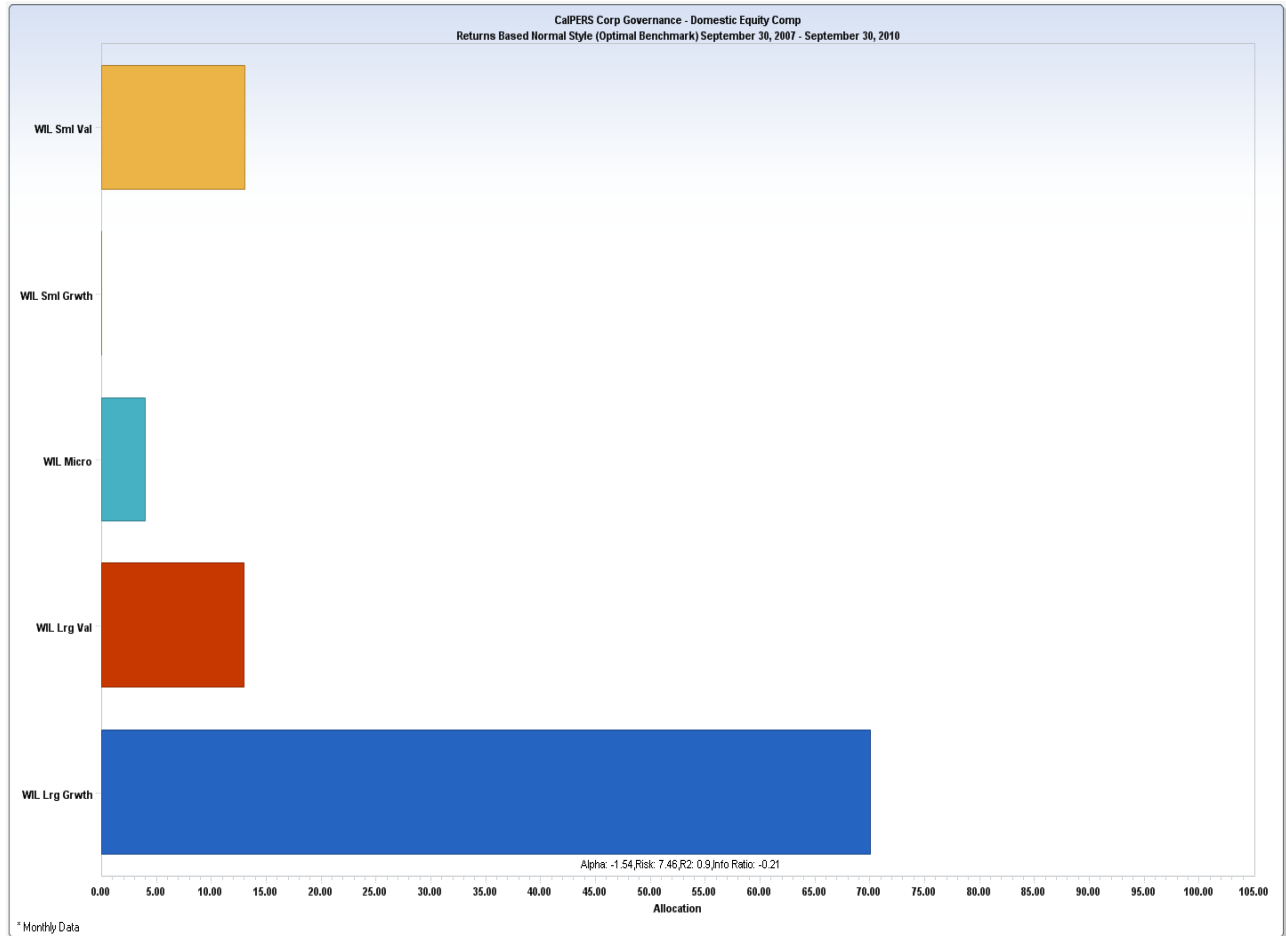


Chart II  
 Corporate Governance Investment Program  
 International Equity – Returns Based Style Analysis

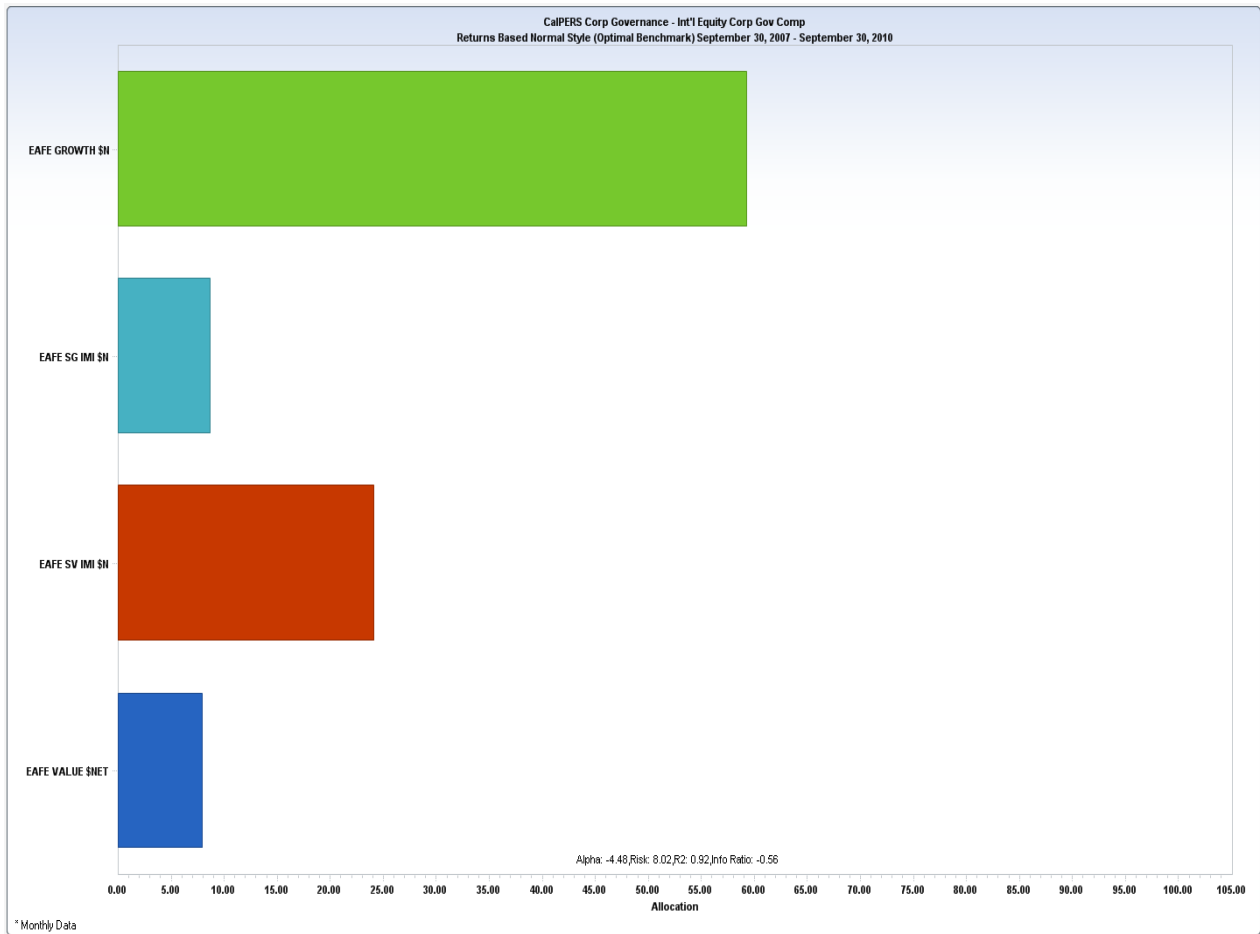


Table I below shows the relative sector weight of the domestic equity portfolio and the international portfolio, relative to the Dow Jones Wilshire 2500 and the MSCI EAFE indices, respectively.

	Relative Sector Weights (%)	
	Domestic CG Comp	International CG Comp
Consumer Discretionary	9.16	1.59
Consumer Staples	-2.30	-0.28
Energy	0.36	-2.19
Financials	-4.68	-19.51
Health Care	9.17	5.54
Industrials	-1.75	14.52
Information Technology	-2.71	16.37
Materials	-2.48	-5.30
Telecomm Services	-2.02	-5.76
Utilities	-2.74	-4.98

As was the case last year, there are meaningful overweights and underweights in almost every sector, both domestically and internationally. This contributes to the active risk level in the overall portfolio, but managers are ultimately pursuing engagements where they feel they can have a meaningfully positive impact on the stock price. Note that both portfolios have meaningful underweights in the Financial sector, which is likely the cause of the growth bias shown in the returns based style analysis as Financials are typically considered value stocks.

The attribution results presented below illustrate the drivers of return in a common factor framework versus the Wilshire 2500 Index. The Wilshire 2500 Index is broadly representative of the US equity market (ex micro cap stocks), but is not the performance index for the domestic portfolio, which is a weighted average of the underlying manager benchmarks.

Domestically, much of the outperformance of the portfolio was driven by the small cap bias in the portfolio. As we have noted, attribution on very concentrated portfolios can be imprecise. However, we believe that there is indicative data that can be gleaned from this analysis.

Performance Attribution Analysis  
CalPERS Domestic Corporate Governance vs. Wilshire 2500  
9/30/09 through 9/30/10

Sources of Returns	Portfolio	Benchmark	Management
Log Market Cap	3.14	0.34	2.80
E/P Ratio	-0.04	-0.03	-0.01
Book/Price	0.55	0.70	-0.14
Volatility	-1.67	-1.33	-0.34
Momentum	0.11	0.80	-0.69
Historic Beta	0.29	0.34	-0.05
Msindgrp	11.22	10.57	0.64
Risk Free Return	0.28	0.28	0.00
<b>Model Return</b>	<b>13.89</b>	<b>11.67</b>	<b>2.21</b>
Selection / Residual	-2.48	-0.70	-1.77
<b>Total Monthly Linked Return</b>	<b>11.41</b>	<b>10.97</b>	<b>0.44</b>

Internationally, country and region weights detracted from returns versus the MSCI EAFE index. As was the case with the domestic portfolio, EAFE is not the Program benchmark, but is representative of the developed non-US investable universe. Again, the Program's benchmark is a weighted average of the actual manager benchmarks. Additionally, the country and region weights are largely a decision made by Staff based on where qualified and talented managers are found.

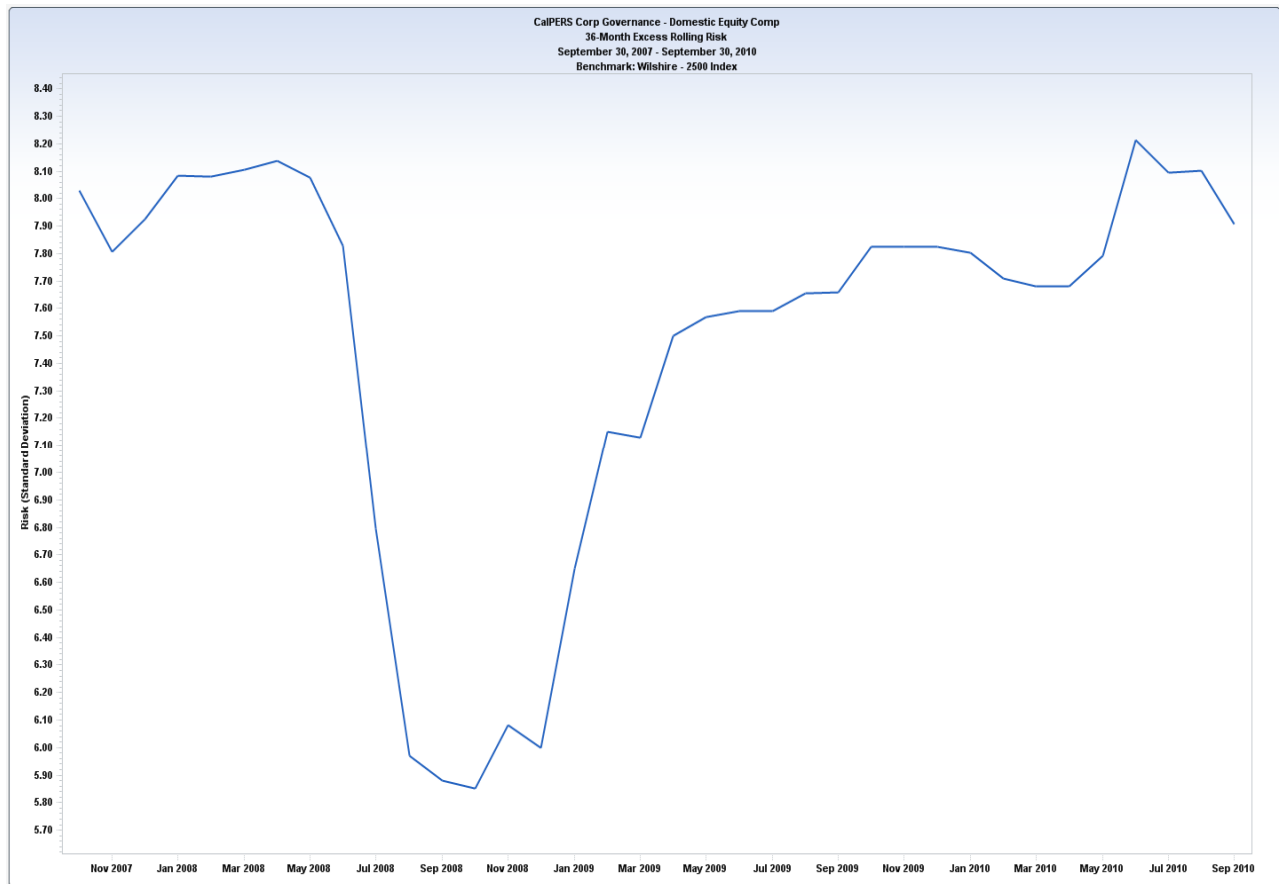
Industry weights and fundamental factors (cap size, style characteristics, etc.) contributed positively to the returns of the international portfolio.

Performance Attribution Analysis  
CalPERS International Corporate Governance vs. MSCI EAFE  
9/30/09 through 9/30/10

Sources of Returns	Portfolio	Benchmark	Management
Currency	3.16	0.03	3.13
Region	2.38	5.91	-3.53
Country	-1.98	0.09	-2.08
Industry	0.69	-2.39	3.09
Fundamental	0.30	0.06	0.24
Risk Free Return	0.40	0.67	-0.28
<b><i>Model Return</i></b>	<b><i>4.95</i></b>	<b><i>4.39</i></b>	<b><i>0.57</i></b>
Selection / Residual	-0.06	-0.45	0.39
<b><i>Total Monthly Linked Return</i></b>	<b><i>4.89</i></b>	<b><i>3.94</i></b>	<b><i>0.96</i></b>

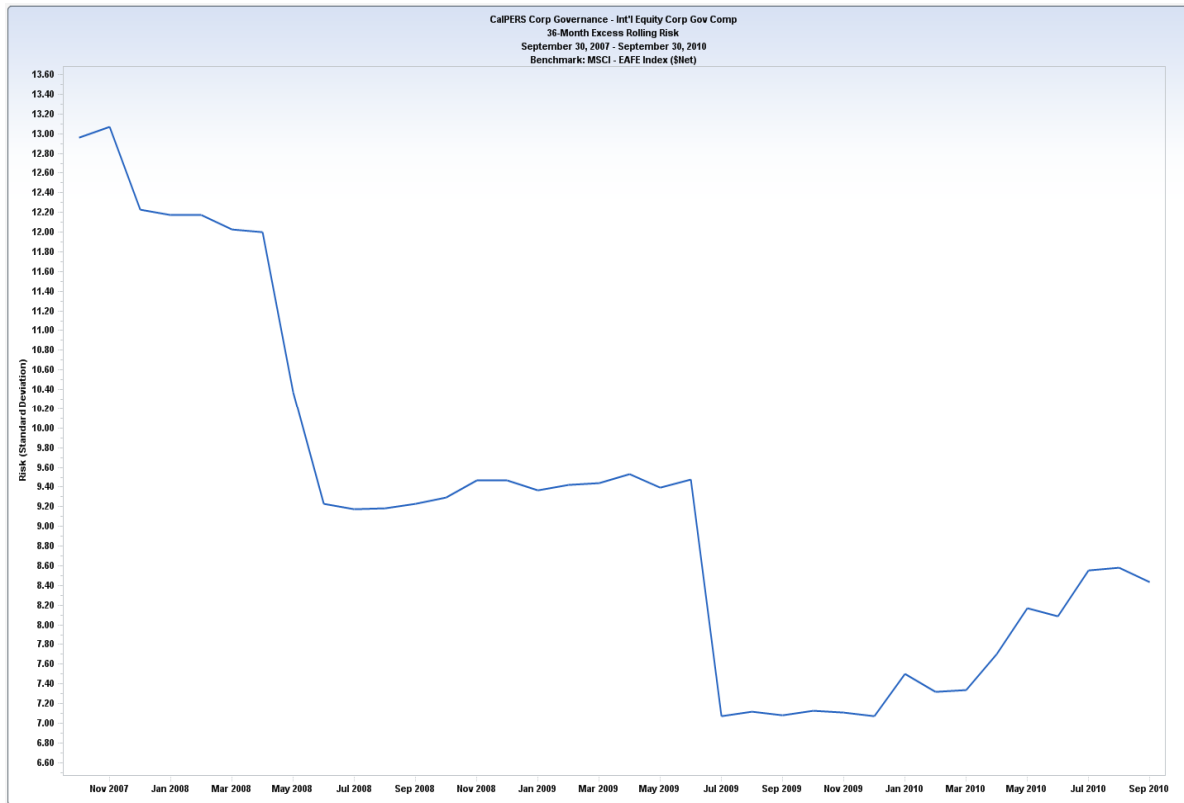
Historically, the concentrated nature of each portfolio has generated meaningful tracking error versus the broad domestic and international equity markets. Over the last three years, the domestic portfolio has experienced tracking error ranging from roughly 6-8% on a rolling three year basis, as shown in Chart III.

Chart III  
Corporate Governance Investment Program  
Domestic Equity – Historical Tracking Error



Over the last three years, the international portfolio has experienced tracking error ranging from 13% to 7% on a rolling three year basis, as shown in Chart IV.

Chart IV  
Corporate Governance Investment Program  
International Equity – Historical Tracking Error



The realized tracking error is not surprising, given the relative sector weights (as demonstrated) and the concentrated nature of the portfolio. Looking forward, both portfolios are expected to continue to demonstrate meaningful tracking error in pursuit of the goal of outperformance, as shown in Table II.

Table II  
Corporate Governance Investment Program  
Summary Analysis  
Ex Ante Estimates - Annualized

	<i>Domestic</i>	<i>International</i>
	<i>Portfolio</i>	<i>Portfolio</i>
Number of Securities	80	94
Total Risk	17.60	18.12
Tracking Error	4.44	8.33
Predicted Beta	0.94	0.82

### Conclusion

In brief, we believe that the Program is well run and Staff is aware of the risks and rewards associated with activist investing. We continue to monitor the role of the Program as Global Equity shifts to its goal of a more holistic approach to investing.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,



Strategy Evaluation: CalPERS Corporate Governance Investments Program

**Organization (0-100)**

**SCORE:**

**COMMENTS:**

Ownership/Incentives (0-30)

Direct Ownership/Phantom Stock  
Profit Sharing  
Performance Bonus  
Depth of Incentives

Employees receive performance bonus only. Bonus is driven by multiple factors, some geared around the investment performance generated by the corporate governance portfolio but others related to total fund performance. Obviously, no equity ownership is available for employees.

Score: 5

Team (0-25)

Communication  
Role of Manager, Research, and Operations  
Longevity of Team

Overall strategic guidance is provided by Eric Baggesen, Anne Simpson, and Kurt Silberstein. The Portfolio Manager has relevant experience in asset management and has demonstrated a passion and aptitude for activist investing.

Score: 20

Quality of Key Professionals (0-15)

Experience  
Quality of Leadership  
Quality of Education

The PM, SPMs and SIO-Global Equities all are technically proficient and have appropriate backgrounds. PM has been in place for a few years and two involved SPMs have gained experience with the nuances of the program since the last review.

Score: 15

Turnover of Senior Professionals (0-15)

Low (<10%), Medium (<20%), High (>20%)

Staff turnover for CalPERS is high at both the senior and junior levels, including the departure of the previous SIO for Global Equities, two CIOs, and the CEO over the last few years. Lack of long-term retention incentives lead some staff to consider the organization as a “stepping stone” to better compensation in similar positions elsewhere.

Score: 0

Commitment to Improvement (0-15)

Clear Mission  
Re-investment  
Process Enhance

Staff is committed to generating alpha through the use of activist strategies utilizing outside managers and co-investment opportunities. This sub-asset class is research intensive and Staff dedicates significant amounts of time to covering existing investments and to sourcing new ideas.

The uncertainty associated with integrating the Program into the holistic view of Global Equity reduces the Program’s score in this area.

Score: 10

**Philosophy/Process (0-100)**

## Corporate Governance Investments Program Review

December 1, 2010

Page 16

### SCORE:

### COMMENTS:

Market Anomaly/Inefficiency (0-40)

Permanent or Temporary  
Clear Identification  
Where and How Add Value  
Empirical or Academic Evidence to Support

Score: 35

Corporate Governance strategies have been studied extensively, with academic finding consistently supporting added value from good or improving corporate governance. Wilshire believes that shareholder activism is a long-term, sustainable source of outperformance, although it is a research intensive strategy and performance can be lumpy. In addition, there is a typically a value bias in these strategies, as poorly governed companies rarely trade at a premium. Activism is not an all weather strategy.

Information (0-15)

Unique Sources, Unique Processing

Score: 12

Sourcing of new fund ideas is conducted by Staff utilizing their existing network of contacts and industry sources. Staff scores proposals by managers – those meeting a minimum acceptable score are passed on to outside consultants for further due diligence and a recommendation.

Staff also actively seeks co-investment ideas from the existing managers, although Staff only invests after thorough due diligence. Not every co-investment opportunity leads to capital being invested. Staff conducts fundamental research on co-investment opportunities and uses CalPERS network to provide external feedback (e.g., contacting Street analysts to discuss a company's prospects).

Buy/Sell Discipline (0-15)

Disciplined/Structured Process  
Quantitative and Qualitative Inputs

Score: 15

Hiring decisions for external managers are made after independent due diligence by Staff and an outside consultant, followed by discussion between Staff and the consultant. Termination decisions are based on performance, engagement process and changes in the view of a manager's process. Co-investment decisions are based on thorough fundamental research; discussions with the proposing manager as to the proposed engagement, its chances of success and risks to a successful outcome; and external research.

## Corporate Governance Investments Program Review

December 1, 2010

Page 17

### Portfolio Construction (0-15)

Benchmark Orientation

Risk Controls

Ongoing Monitoring

Score: 10

Portfolio construction reflects the mandate of the product (e.g., large cap, small cap, emerging markets, etc.) and the anticipated value-added by the manager's process. Staff has recently been given the authority to invest in emerging markets, which expands the opportunity set.

Individual portfolios tend to be very concentrated with holdings ranging from 2-20 per portfolio. Most managers are benchmarked to a core index, rather than a value benchmark, despite the typical value bias of the managers. Sector, size and style biases are ever present, though this risk is being considered and methods to address it are being examined. Some managers are benchmarked to absolute return hurdles, which creates misfit.

Still new capital allocation software and process brings some uncertainty to the portfolio construction process.

### Quality Control (0-15)

Return Dispersion

Performance Attribution

Performance Consistency

Style Drift

Score: 10

Style drift is typically small, as managers are purchasing underperforming (read: value) companies in an attempt to improve the company's performance. Style drift is primarily a function of sector weights, which are an outcome of each manager's process. Attribution is performed by Staff and Wilshire, but concentrated portfolios mean that stock-specific risk is dominant. Both Staff and Wilshire monitor portfolios on a stock-by-stock basis on a continuous basis.

**Resources (0-100)**

**SCORE:**

**COMMENTS:**

Research (Alpha Generation) (0-40)

Appropriate for Product Style  
Conducted Internally/Externally  
Quantitative/Qualitative  
Sufficient Databases and Models for  
Research  
How are Research Capabilities Enhanced

Alpha generation is driven by stock selection and engagement success. Performance can be “lumpy” as not all engagements progress at the same speed. Staff proactively communicates with managers about engagement progress.

Long term results have been good for the Corporate Governance Investments Program and have proven out the value-adding nature of activist investing.

Score: 35

Information/Systems Management (0-15)

Ability to Manage Large Flows of Data  
Appropriate Systems for Research and  
Management

Hardware and software support is very strong. Members of Staff have access to Bloomberg for research and information on current market conditions. New capital allocation software brings some uncertainty to the process.

Score: 14

Marketing/Administration/Client Service (0-15)

Dedicated and Knowledgeable Group  
Quality of Materials/Presentations of RFPs  
Responsiveness  
Measuring Client Satisfaction

Since marketing and client service are not involved, unlike external sources for such a strategy, the full resources of the Staff will be devoted to CalPERS, as the portfolio managers will not have to travel to service other clients or market to prospects. End client (Investment Committee) has regular meetings that usually require SIO and SPM, but team is able to continue to operate in their absence. At present, staffing levels are appropriate.

Score: 14

Trading (0-30)

Turnover Relative to Process  
Sophistication of Trading Process  
Measurement of Trading Costs

Turnover in the Corporate Governance Investments Program is low, so trading costs are low overall. However, position sizes are large and careless trading can move the price of the stock being transacted against CalPERS’ interests. By and large, most trading is conducted by the external managers and those processes are reviewed during the due diligence process. Wilshire’s experience is that the external managers are very careful about trading and are willing to take time to build a position so that there is little information imparted to the market.

Score: 25

Co-investments are frequently traded by CalPERS’ trading desk, which Wilshire believes is an effective mechanism for trading in large blocks.

*Discussion*

Wilshire's score on this strategy of 73% or 220 out of 300 possible points is higher than the 2009 score of 218. Additional improvements would be expected as the holistic Global Equity strategy crystallizes with respect to the future role of this Program.